



February 24, 2009

## **University of California Regents' Committee on Investments**

## **Recommendation to Change Performance Benchmark for Absolute Return Strategies**

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# Absolute Return Benchmark

## Functions of a Performance Benchmark

- Performance benchmarks establish a standard against which the performance of a portfolio for various periods can be evaluated
  - Benchmarks are often market indices where they are available
  - Benchmarks are different from performance objectives which are aspirational and generally have long-term horizons
- Common characteristics of benchmarks:
  - **Unambiguous** -- The names and weights of securities comprising the benchmark are clearly delineated.
  - **Investable** -- The option is available to forego active management and simply hold the benchmark.
  - **Measurable** -- It is possible to readily calculate the benchmark's own return on a reasonably frequent basis.
  - **Appropriate** -- The benchmark is consistent with the manager's investment style or biases.
  - **Reflective of current investment opinions** -- The manager has current investment knowledge (positive, negative or neutral) of the securities which make up the benchmark.
  - **Specified in advance** -- the benchmark is constructed prior to the start of an evaluation period.

## Developing an Appropriate Performance Benchmark

Managers Can Only Add To Returns That Are Available in the Market

- Hedge Fund Research, Inc provides research on hedge funds and hedge fund performance as well as a number of hedge fund-related indices
  - They provide style-specific as well as broad hedge fund market indices
  - There are two that are relevant to our needs
    - HRFX Absolute Return Index – an index comprised of hedge funds with little or no market correlation (low beta and therefore low volatility)
    - HRFX Market Directional Index – an index comprised of hedge funds with moderate or higher market correlation (higher beta and therefore higher volatility)
- The Regent's Absolute Return Guidelines provide for a 'Normal Portfolio' of 50% low-volatility assets and 50% high-volatility assets
- The proposed Performance Benchmark (as differentiated from the Performance Objective) would be
  - 50% HFRX Absolute Return Index and 50% HFRX Market Directional Index
  - This is a real, investible, index portfolio, against which to evaluate active management whose most fundamental characteristic, beta, matches the Guidelines' Normal Portfolio

## Recommendation and Implementation

- Mercer has reviewed the proposed benchmark change and recommends adoption
- The revised Benchmark should be implemented at the first practical month-end after approval of the benchmark change